Chapter VIII

Merger Integration Team Analysis

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Introduction

SBC Communications, Inc. (SBC) and Ameritech Corporation (Ameritech) decided to merge based in large part on analyses that indicated that there were significant opportunities for cost savings, revenue growth, technological development and other synergistic benefits. SBC developed an overall savings goal of more that $2.5 billion per year consisting of individual savings initiatives in more than fifty functional areas of the combined companies. A detailed breakdown of the savings goal is discussed later in this chapter of the report.

In planning to realize the merger savings, SBC established a comprehensive program similar to the one it had used successfully in the mergers with Pacific Telesis Group (PTG) and Southern New England Telephone (SNET). For the Ameritech merger, SBC developed and implemented an Oracle database system to improve its cost and savings tracking and reporting capabilities. To meet the ICC's merger condition relating to sharing of savings with the ratepayers of Ameritech Illinois, SBC also developed a process to allocate Illinois related merger costs and savings to Ameritech Illinois (AI).

Merger Cost and Savings Planning Process

(Description of Process is Redacted)

(Description of Process is Redacted)

(Description of Process is Redacted)

By the end of 1999, savings recommendations were completed for the majority of the merger teams and approved by the TPG. Exhibit MIT-4 is a summary of estimated savings for all of the merger teams. As discussed in Chapter IX, Additional Savings Possibilities, SBC considers fifteen of the teams listed in Exhibit MIT-4 to be outside the scope of this audit with no requirement for the sharing of merger-related savings with ratepayers in Illinois.

Exhibit MIT-4
Planned SBC 2002 Savings (Revenue, Expense and Capital)
(Dollars in Millions)

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(redacted)

Tracking and Reporting of SBC Merger Costs and Savings

In general, merger savings are associated with

- Reduced headcount
- Improved operations
- Procurement benefits

- Best practices
- Change in process.

The individual merger teams are responsible for the implementation of the merger initiatives and the determination of resultant costs and savings. The MIT group provides support to the merger teams and is responsible for the tracking and review of the planned and actual merger costs and savings.

Exhibit MIT-5 is BWG's representation of SBC's process for identifying planned merger cost and savings. As indicated in the exhibit, SBC's process does not allocate planned cost and savings to Illinois. Exhibit MIT-6 displays BWG's understanding of SBC's process for tracking and reporting actual costs and savings from the merger, including comparisons to the plan.

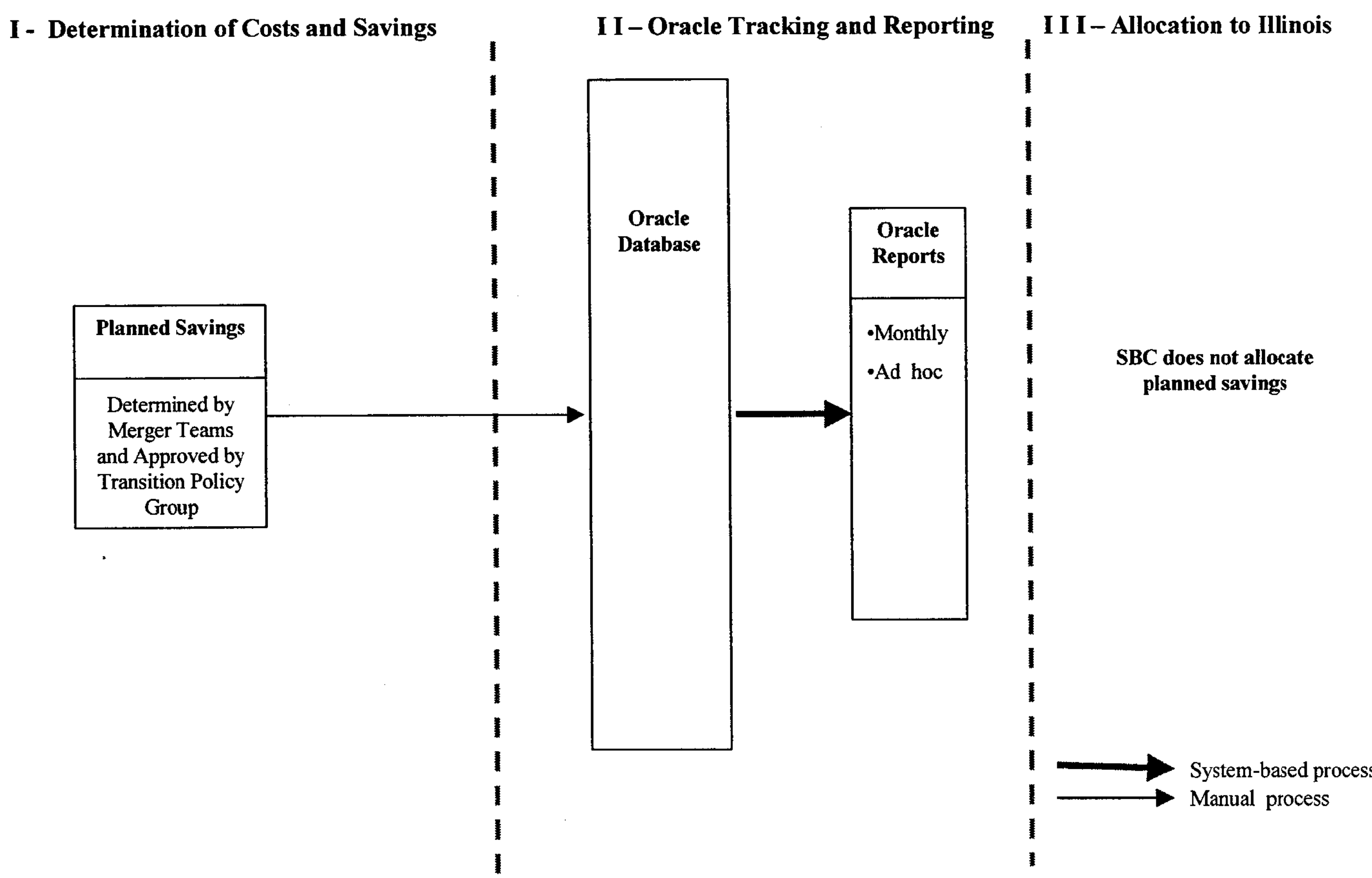
Each initiative may be comprised of several sub-initiatives. For example, the initiative to reduce the mass market installation and maintenance workload is comprised of four sub-initiatives which address different process improvements. SBC has identified approximately 200 merger initiatives and more than 600 sub-initiatives.

Merger savings are calculated and tracked at the sub-initiative level by each Team. Merger savings are not identified, tracked, or calculated by the financial accounting system. Rather, savings must be calculated based on methodologies specific to each sub-initiative. For example, the savings associated with construction productivity are determined using productivity measures, construction hours, full time equivalents, labor rates, benefits and trailing expenses, while the savings associated with contract renegotiation are determined based on a comparison of old and new contract prices. The sources of savings data vary among the various SBC entities due to the availability of specific reports and information requirements.

Recurring costs represent those ongoing costs necessary to achieve savings and include items such as salaries from force additions or increased contractor costs related to an out-sourcing sub-initiative. Recurring costs may be tracked using a separate tracking code, at the team's discretion, or may be compiled based on data from various sources depending on the specific circumstances. Force–related costs and savings may be calculated in the Oracle database as discussed further below.

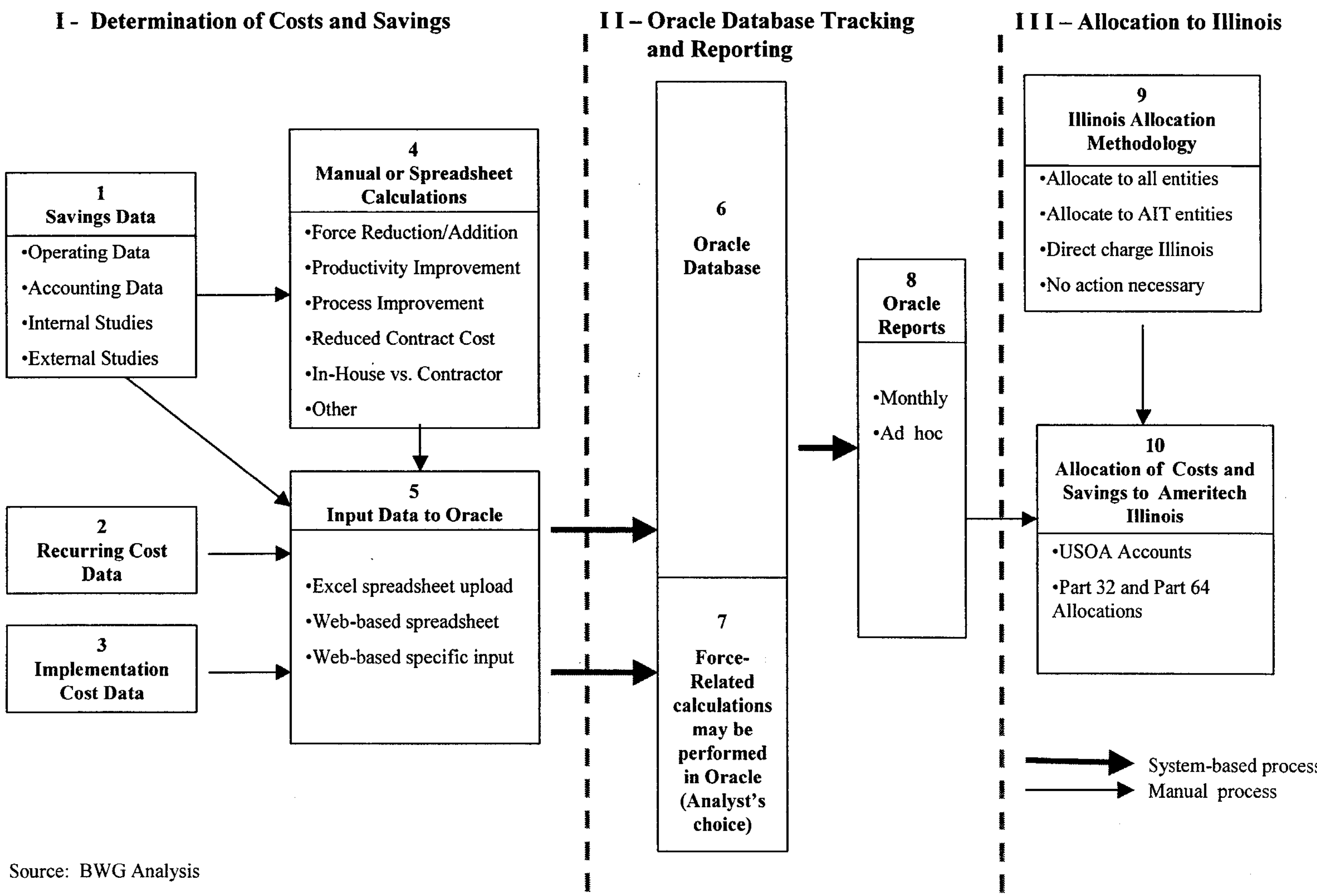
Exhibit MIT-5

SBC Process to Track and Report Planned Merger Costs and Savings



Source: BWG Analysis

Exhibit MIT-6
SBC Process to Track and Report Actual Merger Costs and Savings



Source: BWG Analysis

Implementation costs include items such as salary and wages, training expenses, system development, hardware and software, capitalized assets, and severance and relocation necessary to achieve future savings. After team initiatives were identified and approved by the TPG, SBC established team-specific codes to track expense and capital costs to implement team initiatives. Tracking codes are company-specific and are incorporated within SBC's accounting systems.

SBC developed an internet-based Oracle database to track the costs and savings associated with the Ameritech merger.[xvi] The Merger Tracking database is a stand-alone system. Information is input to the database by each merger team at the sub-initiative level. Data may be uploaded to Oracle by an excel spreadsheet or entered directly into the Oracle database.

The Oracle database tracks planned and actual implementation costs, savings and labor force information for each MIT sub-initiative. Sub-initiative level information can be aggregated to provide reporting at the initiative or team level. Implementation costs and savings are each tracked separately, and are not netted within Oracle; however, expense and capital savings are shown net of recurring expenses and capital.

Oracle tracking is performed using the detailed hierarchy provided in Exhibits MIT-7 and MIT-8 (following). The hierarchy includes three major categories of savings (revenue, expense and capital) with associated detail, and two major categories for implementation costs (expense and capital) with associated detail. Detail is also provided for labor force additions and reductions.

Exhibit MIT-7
Oracle Hierarchy – Force Information

Hierarchy Levels	Sub-Levels
.03.Force Impact	
.03.01..Additions	.03.01.01...New Hires (Management and Non-Management) .03.01.02...Relocation In (Management and Non-Management) .03.01.03...Temporary .03.01.04...Contractors
.03.02..Reductions	.03.02.01...With Termination Pay (Mgmt and Non-Mgmt) .03.02.02...Without Termination Pay (Mgmt and Non-Mgmt) .03.02.03...Relocation Out (Mgmt and Non-Mgmt) .03.02.04...Temporary .03.02.05...Contractors .03.02.06...Vacancies

Source: Oracle Report Sample (Document Request EAL 5).

[xvi] SBC had used an Excel spreadsheet for the tracking of savings in the SBC/PTG merger, but determined a need to upgrade its tracking capabilities using a newly-developed Oracle system.

Exhibit MIT-8
Oracle Hierarchy – Savings and Implementation Cost Information

Hierarchy Levels	Sub-Levels
.01.Savings	
.01.01..Revenue	.01.01.01...Net Revenue .01.01.03...Other
.01.02..Net Expense Savings (Savings less Recurring Expense)	.01.02.01...Expense Savings .01.02.01.01....Wages (Calculated and Not Calculated) .01.02.01.02....Benefits .01.02.01.04....Other (Calculated and Not Calculated) .01.02.01.05....One Time .01.02.02...Recurring Expense .01.02.02.01....Wages (Calculated and Not Calculated) .01.02.02.02....Benefits .01.02.02.04....Other (Calculated and Not Calculated) .01.02.02.05....IT .01.02.02.06....Real Estate
.01.03..Net Capital Savings (Savings less Recurring Capital)	.01.03.01...Capital Savings .01.03.01.01....Wages .01.03.01.02....Benefits .01.03.01.03....RTU .01.03.01.04....Other .01.03.01.05....One Time .01.03.02...Recurring Capital .01.03.02.01....Wages .01.03.02.02....Benefits .01.03.02.03....RTU .01.03.02.04....Other
.02.Implementation Costs	
.02.01..Implementation Expense	.02.01.01...Wages .02.01.02...Benefits .02.01.04...Network .02.01.05...IT .02.01.06...Real Estate .02.01.07...RTU .02.01.08...Accrued Upfront .02.01.09...Termination .02.01.10...Relocation .02.01.11...Other
.02.02..Implementation Capital	.02.02.01...Wages .02.02.02...Benefits .02.02.04...Network .02.02.05...IT .02.02.06...Real Estate .02.02.07...RTU .02.02.08...Other

Source: Oracle Report Sample (Document Request EAL 5).

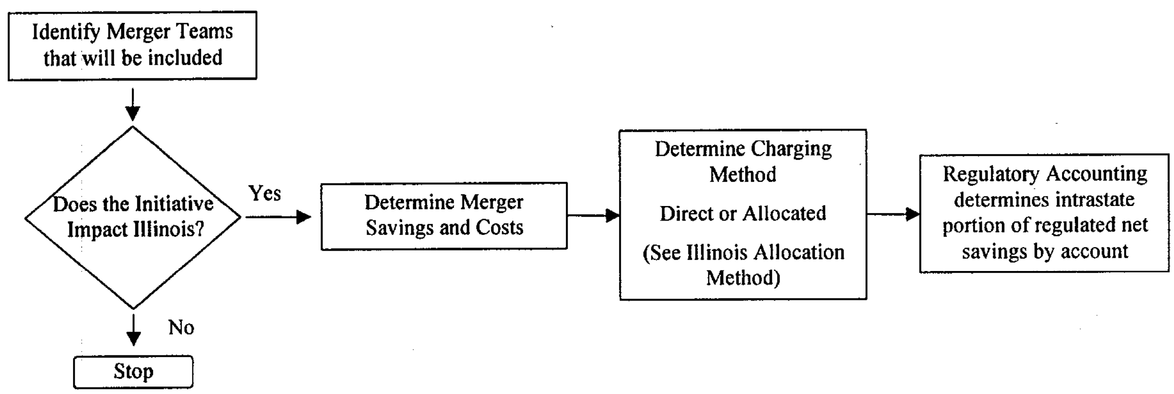
The Oracle database is a tracking tool. With the exception of force-related savings, it does not calculate savings, nor is there any direct link between the Oracle database and the general accounting system. The database will calculate the costs and savings associated with force additions or reductions using input wage rate and trailing expense information and standard benefit rates built into the Oracle system.

Allocation to Illinois

The Oracle database captures SBC-wide costs and savings and does not allocate savings and costs to Illinois. The merger teams and the MIT group will perform the allocation of costs and savings to Illinois off-line using a decision tree process to assess whether each team sub-initiative has Illinois intrastate regulated net savings and to determine whether Illinois savings should be based on direct charges or allocation. Once the MIT determines the general allocation methodology, Regulatory Accounting will develop the specific allocation factors to determine the intrastate portion of regulated cost and savings by account. The Illinois allocation is performed solely for the purpose of reporting savings to the Commission. The allocation of 2000 merger costs and savings will not be performed until early 2001.

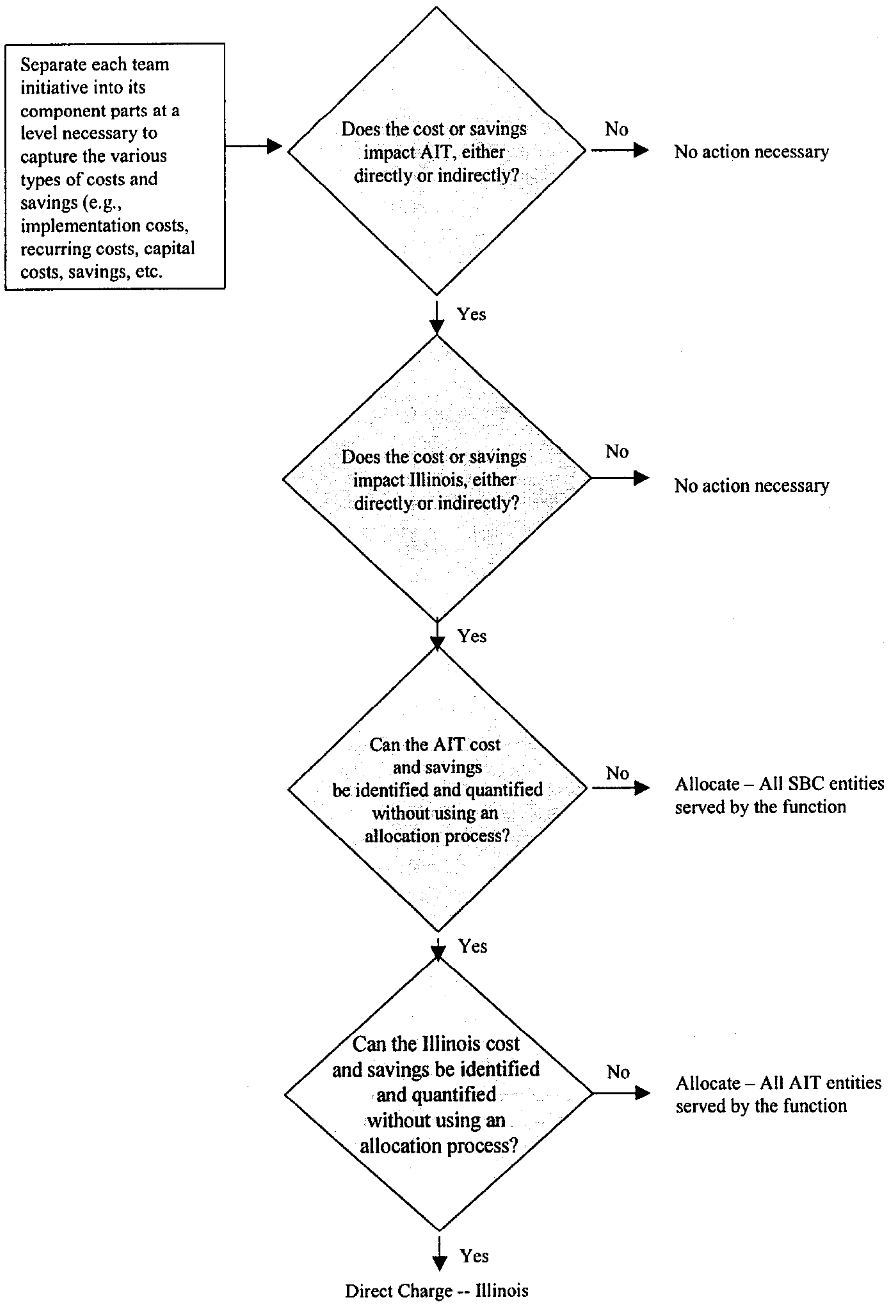
An overview of the Illinois allocation process is shown in Exhibit MIT-9 and Exhibit MIT-10.

Exhibit MIT-9
Illinois Allocation Process



Source: SBC Handout at Interview DPV-9, June 20, 2000,

Exhibit MIT-10
Illinois Allocation Method



Source: SBC handout at Interview DPV-9, June 20, 2000.

Hypothetical Questions

During the merger hearings, the Chairman of the Commission posed several hypothetical questions relating to the determination of merger related costs and savings. The questions addressed a wide range of potential issues, from the treatment of enhanced revenues and avoided costs to the savings impact of increasing the spans of control for the supervision of workers in Illinois by managers in other locations. Throughout the audit, BWG considered the implications of these questions in the context of the Company's approach to the savings calculations. By the end of the audit, our investigation has determined that SBC's merger savings process permits the Company to address many complex issues similar to those raised in the hypothetical questions. As explained throughout this chapter of the report, SBC developed specific cost and savings methodologies for each merger sub-imitative. This approach provides the flexibility the Company needs to address complex issues on an ad hoc basis.

Objectives

The objectives in this task area have evolved over time. In planning the audit, we expected to be able to identify and quantify merger cost and savings for the first quarter 2000. As discussed in the findings below, during the course of the audit we learned that SBC will not have final merger costs and savings information for 2000 available until early 2001.[xvii] The objectives of this task area have necessarily been modified to reflect an assessment of SBC's merger savings determination and tracking process, rather than the identification and quantification of actual savings.

The objectives for this task area are as follows

- Determine whether SBC has an adequate process to identify and quantify incremental merger-related costs and savings.
- Determine whether SBC has an adequate process to allocate merger costs and savings to Illinois.
- Determine whether implementation of any of the merger team recommendations will likely result in degradation of service to AI customers.
- Review the process SBC plans to use to compile its Year 2000 Merger Cost and Savings Report required to be filed with the Commission by March 31, 2001.
- Use the information obtained to assist the Commission Staff determine the need for, scope, and timing of its review of actual Year 2000 cost and savings information when it is filed by the Company.

[xvii] It should be noted that SBC has provided actual savings data for the year 1999. BWG's assessment of these data is addressed in Chapter VIII, Reported Costs and Savings

Evaluative Criteria

BWG performed this review and evaluation using the following evaluative criteria:

- Has the Company developed an adequate process to identify and quantify incremental merger-related costs and savings?
- Has the Company developed an adequate process to identify the Ameritech Illinois portion of all costs and savings associated with the merger team initiatives?
- Does the documentation developed by the merger teams provide sufficient information so that the Commission can assess the reasonableness of merger-related costs and savings?

Summary of Audit Procedures

The procedures in this task area have also evolved during the course to the audit. Most notably, we developed an MIT process verification procedure to assess SBC's cost and savings determination processes for selected sub-initiatives. This procedure and other tasks performed in this area are described below.

- Reviewed merger hearing filings to identify expected merger-related costs and savings. Identified cost and savings issues that require further resolution.
- Evaluated how the Company's decisions with respect to merger-related costs and savings are communicated to officers and employees responsible for implementation.
- Interviewed representatives from each of the merger teams associated with the Company's regulated business as shown in Exhibit MIT-11 (page following.) Interview participants generally included the team leader, other team members and participants, the team's business or financial analyst, and a representative from the senior management group responsible for implementing the merger.
- During each interview BWG completed the following data collection, analysis and evaluation activities:

  ⇒ Completed a standard checklist and used a form to record the names of key personnel involved in developing the recommendations, cost and savings targets and projections, net force reductions, individual recommendations and their associated net present values.

  ⇒ Reviewed the recommendation summaries and inquired during the interviews regarding several subjective areas of our investigation. We sought to determine whether the savings were the result of the adoption of best practices or economies of scale. If the savings resulted from a best practice, we determined whether the best practice came from Ameritech or from one of the other companies.

  ⇒ Evaluated each recommendation to determine whether its implementation might adversely affect service quality.

⇒ Determined whether the costs and savings associated with each recommendation were complete and logical.

⇒ Identified the likelihood of Illinois specific costs and savings for each recommendation.

⇒ Inquired about progress to date on implementing the recommendations and the amount of any savings realized since the date of the merger.

Exhibit MIT-11
BWG Merger Team Interview Schedule

Date	Team	Date	Team
April 27	26 - Holding Company Finance	June 5	38 - Telcordia
May 22	2 - Real Estate	June 5	19 - Bill Production
May 22	13 - Business Sales	June 5	5 - Network Switching and Transport
May 22	6 - Network Planning & Engineering 7 - Network Software RTU	June 7	34 - Information Management
May 23	27 - External Affairs	June 7	3 - IT Services 4 - Data Processing/RTU 99 - IT Infrastructure
May 23	23 - Legal	June 20	37 - Payroll Operations
May 24	24 - Strategic Planning 25 - Corporate Development	June 20	21 - Credit and Collections
May 24	42 - Capital Management	June 21	35 - Procurement Operations
May 24	20 - Bill Remittance	June 21	59 - Procurement Spending
May 25	16 - Advertising	June 21	39/54 - Industry Markets & Interconnection Services
May 25	18 - Operator Services	June 21	14 - Consumer Sales Operations
May 25	17/41 - SBC Strategic Marketing	June 22	29 – Benefits
May 25	32 - HR-Holding Company	June 23	31 – Training
May 26	36 - Technology Resources	June 22	10 – Network Staff
May 26	1 - Fleet Operations	July 10	56 - Design/High End Special Services
May 26	12 - Telemarketing	July 17	8 - Mass Market Installation and Maintenance
June 5	11 - OSP Construction & Engineering		

Source: BWG Interview Schedule, Merger Team Interview Folders.

MIT Process Verification

BWG selected 35 merger team sub-initiatives for detailed testing and review. From the list of initiatives with planned savings in the year 2000, we selected two sub-initiatives for each type of calculation methodology outlined in the team savings calculation worksheets. Selected sub-initiatives are listed in Exhibit MIT-13 (following page 17). An overview of the sub-initiatives selected for testing is provided below:

Exhibit MIT-12
Overview of Sub-Initiatives Selected For Testing

	Total (1)	Selected by BWG	Percent Selected by BWG
Number of Sub-Initiatives	413	35	8%
Number of Teams	39	24	62%
Planned 2000 Savings (Dollars in Millions)	$751	$309	41%

(1) Totals based on in-scope initiatives with planned savings in the year 2000. Data reflect information available during the selection process in July 2000. Subsequently, SBC has changed some of its savings projections.

Source: Spreadsheets received by e-mail in response to Document Request EAL-5 and on July 11, 2000 from the Director of Transition Planning.

BWG's testing of selected sub-initiatives was a three-stage process:

Stage 1 From September 11 through 14, 2000 the audit team reviewed the data SBC provided for the selected sub-initiatives. At that time, BWG determined that the data were insufficient or not sufficiently organized for the review.

Stage 2 Following a September 26, 2000 meeting attended by BWG, the ICC Staff and Company representatives, SBC prepared more detailed audit review packages. BWG, the ICC staff, and SBC representatives reviewed the audit packages from October 17 to 19, 2000. SBC MIT Lead Finance and Business leads, as well as the analysts responsible for the selected sub-initiatives attended these meetings. BWG issued several follow-up questions in one data request as a result of this process verification meeting.

Stage 3 In early November 2000, BWG reviewed additional documentation provided in response to follow-up questions in order to complete the verification of the Company's process.

The following are the specific tasks performed in the process verification review:

- Determined whether overall savings calculation methodology is appropriate.
- Assessed source of data used in savings calculations and determined whether data is appropriately used.
- Determined whether costs are properly associated with the sub-initiative and that they are assigned proper tracking codes.
- Reviewed Oracle merger database reports to determine the database correctly tracks merger team costs and savings information.
- Reviewed the Illinois Cost Allocation decision tree for the sub-initiative to determine whether SBC has identified the proper cost allocation methodology to be used.

Exhibit MIT-13
Merger Team Sub-Initiatives Selected for Testing
(Dollars in Millions)

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Exhibit MIT-13
Merger Team Sub-Initiatives Selected for Testing
(Dollars in Millions)

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Findings and Conclusions

1. The documentation developed by the merger teams provides sufficient information to enable the Commission to assess the reasonableness of planned merger-related costs and savings.

   - Recommendation summaries developed by the individual merger teams are thorough and complete. The Executive Summary for each merger team provides sufficient information to describe the means by which the team intends to achieve the savings. The Recommendation Summary restates each of the initiatives or individual recommendations, and specifically lists its respective implementation costs, expense savings and capital savings. The Recommendation Summary also provides a description of the activities needed for implementation. The Merger Plan Summary provides financial and force information in tabular form.

   - The Financial/Service/Operational Comparisons section provides the information needed to compare and contrast the companies (PacBel, SWBT and AIT) to each other. This section was used, where applicable, to show pre-merger levels of plant equipment, employees, etc. that were used to establish the baseline for the recommendation. Explanations of differences, key service metric comparisons and operational measures were included in this section.

   - The Recommendations section provides a thorough discussion of the team's overall effort, as well as a complete explanation of each initiative or recommendation. Where applicable, tabular information was provided to clearly explain such things as head count reductions by Company.

   - The Employee Force Report and Financial Detail sections provide sufficient information in tabular form to clearly indicate the number of full-time employees by location, identified for relocation, addition and termination, and the costs and savings associated with the recommendations.

   - The standard format made the review process easy and facilitated the comparison of one recommendation or team to another.

   - All of the merger teams reported that implementation of the recommendations was proceeding according to plans.[xviii] Most teams were able to describe specific actions taken; however, none of the teams were prepared to discuss actual savings since the date of the merger.

[xviii] As the audit progressed, BWG noted several deviations from the original implementation schedule and plan.

2. The merger teams adequately identified and quantified planned merger-related costs and savings.

   - Targets for the total savings to be achieved by the individual teams were set above the external commitment because all merger team initiatives have risk and may not achieve their targeted savings.

   - The Transition Policy Group (TPG) made clear to the teams that the targets were firm and not negotiable. The only exception was that benchmarking errors could be corrected, but only if it made a difference. Additional study was performed only if it was essential to the development of the recommendations. It was understood that recommendations would result in savings or revenue growth for the combined companies based on identification of best practices or opportunities for improvement from all companies.

   - Most teams met in one of two Company locations to facilitate the resolution of cross-team issues and ensure the accessibility to personnel on the Merger Integration Team group. As necessary, field visits were made to gain a more complete understanding of methods and practices of the companies. Site visits were limited by using available information as much as possible to determine where best practices existed and which sites, if any, needed to be visited. (redacted)

   - (redacted)

   - Team leaders and members worked on the project on a full-time basis.

   - Planned costs and savings are primarily related to eliminating or consolidating work functions, making productivity improvements or lowering unit costs for purchased goods and services. Implementation costs will include both capital and expense items, and cover such things as wages and salaries, overhead, severance payments, system development costs, hardware and software purchases, and capitalized assets. Merger savings will be generated mainly through reduced headcount and lower procurement costs.

     (redacted)

- In order to facilitate the process, best practices were adopted from previous efforts on the mergers with PacBel and SNET. Team building guidelines were provided for the team leaders. Team behaviors to be avoided were also stressed in the instructions provided at the beginning of the process.

3. While the Oracle merger tracking database is an effective tool for summarizing and reporting information regarding the status of merger costs and savings, it currently contains only preliminary data for the year 2000 on a year-to-date basis.

   - The Oracle database collects and tracks planned and actual/projected implementation costs, savings, and labor force information. The database has on-line reporting capabilities which allow users to create ad hoc reports for specific merger teams or SBC companies using the hierarchy of cost, savings and force information.

   - Final information regarding merger costs and savings for the year 2000 will not be available until early 2001. The MIT group will verify the information tracked in the Oracle database prior to the release of final merger savings data.

   - It is likely that the MIT group verification process will result in changes to the Oracle information. As discussed in Finding 13 below, SBC identified the need to update Oracle information and make adjustments to 25 of the 35 sub-initiatives selected by BWG for detailed review.

   - The tracking and verification of merger cost and savings information is an evolving process. SBC did not complete the development of the Merger Tracking Database until June 2000. The first Oracle reports were not issued until the end of June 2000. In Fall 2000, MIT was still reviewing processes to ensure that costs and savings are calculated and tracked properly in the Oracle database.

4. The principal means for verification of merger costs and savings data is the review of results by the team's finance contact and the team lead prior to inputting data into the Oracle model. MIT analysts review the results on a monthly basis; however they may not identify all necessary adjustments until a more thorough initiative review involving Transition Planning management personnel is completed.

   - With the exception of force-related data, monthly cost and savings information is compiled and calculated off-line, then input manually to the Oracle system by the merger team analysts. Costs and savings associated with force additions or reductions may be calculated by the system using input wage rate information and trailing expenses and standard benefit rates built into the system.[xix] There are three means of data input:

     ⇒ Excel spreadsheet upload
     ⇒ Web-based spreadsheet
     ⇒ Web-based specific input

[xix] The Company uses the term Trailing Expenses to capture non-wage costs associated with employees other than wages, bonuses, and benefits. Trailing Expenses include items such as travel, office supplies, training, and communications that are estimated and applied to direct labor in some initiatives.

- There is no written documentation or training manual relating to the input of cost and savings information to the Oracle database. According to SBC, the MIT analysts provided comprehensive one-on-one training to finance contacts for each merger team. Tracking guidelines and training materials are also available on-line in help screens contained within the model.

- There is no formal review of data by the MIT group prior to input to the Oracle system. MIT analysts perform an on-line review of each teams' monthly results.

5. SBC has a formal process in place to track and review the merger team implementation costs.

   - The SBC-AIT Merger Tracking guidelines provide general descriptions of the types of charges to be included as implementation costs.

   - Merger implementation (one time) costs are tracked using merger Responsibility Codes (RCs) established for each merger team. On-going costs are charged to respective departmental RCs.

   - On a monthly basis, each merger team obtains reports from various accounting systems to identify charges to its specific merger RC or project tracking codes.

   - Each merger team is responsible for validating all expenses reported to the MIT. The MIT reviews these charges against the merger team's current plans and investigates any variances.

   - Implementation costs tracked in the Oracle database are verified through reconciliation with RC or project tracking code reports from the Company's various finance organizations.

6. While the use of a decision tree approach to allocate identified merger costs and savings to Illinois is appropriate, we are unable to verify SBC's process to determine AI regulated/intrastate savings as SBC has not yet performed the required analysis.

   - During the planning stages, teams were instructed to focus their attention solely on identifying, analyzing and recommending the most efficient and productive solutions for the post-merger strategies, operations, realignments and functional organizational structures. The individual teams were specifically told not to take into account regulatory commitments when considering or developing their recommendations. Instead, the Transition Policy Group and the Merger Integration Team addressed this issue after each of the teams developed their recommendations.

   - As previously shown in Exhibit MIT-10, the decision tree process identifies the general allocation methodology (allocate to all SBC entities, allocate to all AIT entities, or direct charge to Illinois), but does not determine specific allocation factors. Following the Merger Team's identification of the allocation methodology, regulatory accounting must develop and apply allocation factors to determine cost by USOA account and the AI regulated/intrastate net savings.

- The process for the allocation of merger savings to Illinois in 2000 will be essentially the same as that which was used for reporting 1999 merger costs and savings. Merger team costs and savings will be assigned to specific USOA accounts. While many of the merger teams are associated with specific USOA accounts, in many cases teams may be related to more than one account and the account assignment will be determined by the MIT group and regulatory accounting. The assignment to specific USOA account is critical as the USOA account determines the Part 64 allocation factor and the intrastate separations factor.

- SBC does not plan to perform this analysis until early 2001.

7. An overview of planned savings in the years (redacted) indicates that SBC expects to achieve approximately (redacted) of its run-rate savings by (redacted), the end of the three-year Illinois savings recovery period. SBC planned savings increase from approximately (redacted).

   - Exhibit MIT-14 depicts the total savings for the years 2000-2004, and indicates the amount attributed each year to increased revenue, expense savings and capital savings.

Exhibit MIT-14
Summary of Planned Merger Savings
(Dollars in Millions)
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- Net wage and benefit savings account for approximately 55 percent of net planned savings shown in Exhibit MIT-15. This includes the impact of force reductions as well as productivity improvements.

Exhibit MIT-15
Percentage Breakdown of Planned Merger Savings
(Dollars in Millions)

	2000	2001	2002	2003	2004
Revenue	1%	2%	2%	2%	2%
Net Expense Savings	69%	75%	78%	79%	79%
Expense Savings	97%	109%	112%	111%	111%
Wages	35%	45%	47%	49%	50%
Benefits	12%	16%	16%	17%	17%
Other	46%	47%	48%	45%	44%
One Time	3%	1%	0%	0%	0%
(Recurring Expense)	(28%)	(33%)	(34%)	(32%)	(32%)
Wages	(8%)	(9%)	(9%)	(9%)	(10%)
Benefits	(3%)	(3%)	(3%)	(3%)	(3%)
Other	(17%)	(21%)	(22%)	(20%)	(19%)
Net Capital Savings	30%	23%	20%	19%	19%
Capital Savings	38%	30%	27%	27%	26%
Wages	2%	3%	3%	3%	3%
Benefits	1%	1%	1%	1%	1%
RTU	1%	0%	0%	0%	0%
Other	29%	23%	22%	22%	22%
One Time	6%	2%	0%	0%	0%
(Recurring Capital)	8%	7%	7%	(8%)	(7%)
Wages	0%	0%	0%	0%	0%
Benefits	0%	0%	0%	0%	0%
Other	(8%)	(7%)	(7%)	(7%)	(7%)
Total Savings	100%	100%	100%	100%	100%

Source: Data Request ALA-25; BWG Analysis

- An overview of planned force additions and reductions is provided in Exhibit MIT-16 through Exhibit MIT-18 below. The numbers shown in these tables include the elimination of anticipated future force additions, relocations out, vacancies that will not be filled, and reductions in the number of contract employees.

Exhibit MIT-16
Planned Merger Related Force Additions and Reductions

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- According to current plans, SBC will achieve only (redacted) percent of planned savings in the first three years, but will have expended (redacted) percent of the implementation costs. Normally, implementation expenditures are made before savings are realized. A breakdown of projected implementation costs is shown in Exhibit MIT-19 below.

Exhibit MIT-19
Summary of Planned Merger Implementation Expenses
(Dollars in Millions)

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9. If planned savings are achieved on a company-wide basis, a significant amount of savings will be realized in Illinois.

   - Although the Company has not performed a detailed review of the potential for savings in Illinois, as shown in Exhibit MIT-20, based upon information obtained during discussions with SBC personnel early in the project, the merger teams that are expected to have a high impact on Illinois constitute approximately 75 percent of the total planned run rate savings on a company-wide basis.

- According to current plans, SBC will achieve only 96 percent of planned savings in the first three years, but will have expended 99 percent of the implementation costs. Normally, implementation expenditures are made before savings are realized. A breakdown of projected implementation costs is shown in Exhibit MIT-19 below.

Exhibit MIT-19
Summary of Planned Merger Implementation Expenses
(Dollars in Millions)

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9. If planned savings are achieved on a company-wide basis, a significant amount of savings will be realized in Illinois.

    - Although the Company has not performed a detailed review of the potential for savings in Illinois, as shown in Exhibit MIT-20, based upon information obtained during discussions with SBC personnel early in the project, the merger teams that are expected to have a high impact on Illinois constitute approximately 75 percent of the total planned run rate savings on a company-wide basis.

Exhibit MIT-20
Planned 2002 Savings (Revenue, Expense and Capital)
(Dollars in Millions)

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10. As shown in Exhibit MIT-21, only 13 of the 168 merger initiatives are solely related to the export of best practices from Ameritech to the other SBC companies, indicating that ratepayers in Illinois will benefit from the merger.

    - BWG determined that approximately 34 percent of the applicable savings initiatives are based on adoption of best practices, with about 8 percent coming from Ameritech. We found that approximately 52 percent of the recommendations are related to economies of scale, coming from the renegotiation of purchasing contracts based on larger volumes, for example. The remaining recommendations represent a mix, of best practices combined with savings generated through economies of scale.

Exhibit MIT-21
Sources of Potential Savings

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Exhibit MIT-21
Sources of Potential Savings

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Sources of Potential Savings

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Exhibit MIT-21
Sources of Potential Savings

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11. Although SBC developed its merger savings recommendations based on the assumption that service levels would be maintained, certain merger team recommendations have a potential effect on service quality.

    - During the merger team interviews, SBC personnel stated that they were not aware of anything that would have a negative impact on service. They also generally reiterated that all recommendations were developed based on the assumption that the Company would continue to maintain required service levels.

    - There are no references to service levels in the Merger Integration Guidelines. Nonetheless, we found no evidence that a change in service levels was either required or implied as a prerequisite to implementing any of the recommendations.

- However, based upon information obtained during the merger team interviews, eight recommendations, accounting for more than $100 million in savings during the three-year period 2000-2002, have a possible negative impact upon service quality. These recommendations are listed in Exhibit MIT-22, with BWG's assessment of their potential service quality effects.

Exhibit MIT-22
Merger Team Initiatives with Possible Service Quality Impact
(Dollars in Millions)

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12. SBC has established formal, well-documented methodologies for the calculation of merger cost and savings associated with each sub-initiative. However, as explained in Findings 13 through 15 below, the process is inherently complex and sometimes relies upon assumptions that are not subject to verification.

- SBC has formal savings methodology work sheets which contain the following information:

  ⇒ Entities and organizations impacted

  ⇒ Savings calculation methodology (generally an equation)

  ⇒ Data sources

  ⇒ Tracking codes by initiative for all entities impacted

- The cost and savings methodologies are developed to address the particular needs and peculiarities of each sub-initiative. This flexibility permits the Company to address some of the more complex savings calculation issues.

- A representative sample of savings calculations are shown below.

Exhibit MIT-24
Sample Savings Calculations

Sample Productivity Improvement Savings Calculation

$$[\{(((\text{Distributed Hours}_{\text{Base}}/\text{SS I\&M Dispatches}_{\text{Base}}) - (\text{Distributed Hours}_{\text{Actual}}/\text{SS I\&M Dispatches}_{\text{Actual}})) * \text{SS I\&M Dispatches}_{\text{Actual}} * \text{Hourly Labor Rate}) + \text{Benefit Impact} + \text{Trailing Expense Savings}_{\text{Actual}}\} * (1\text{-Non Merger Productivity Impact}_{\text{Actual}}) * \text{Expense/ Capitalization Impact}_{\text{Actual}}$$

Where:

Distributed Hours /SS I&M Dispatches	Productivity measurement based on total number of distributed hours worked by special Services field technicians and the number of dispatches for these technicians.
SS I&M Dispatches	Installation and repair dispatches for the Design/High-End (Special Services) technician.
Hourly Labor Rate	Blended overtime and base hourly rate for I&M technicians
Benefit Impact	Determined as (redacted) per FTE and (redacted) of wage savings/expense. Calculated by model. (Oracle database)
Trailing Expense Savings	Includes any non-wage expense that would be incurred including traveling/training, supplies, minor materials, etc.
Non-merger productivity Impact	Impact on productivity, if any, due to other business projects not related to the merger.
Expense/Capitalization Impact	Clearance impact of incurred cost of expense and capital. For expense savings calculation, equal to percent of incurred cost book to expense. Similar for capital savings.
Recurring Expenses	Offset to savings. Identifies all recurring expenses associated with this project, if any, including additional personnel with trailing expenses, contract services, cellular, PC, lease, hardware/software maintenance, etc.

Sample Employee Reduction Savings Calculation
Employee Savings (Force Reduction)*(Annual Wage + Annual bonus) * (1 + Variable Benefits Rate) + Flat Rate Benefits + Trailing Expense] Where: Wage = average wages Bonus = annual bonus, i.e., Team Award, Individual Discretionary Award Variable Benefits Rate = (redacted) of wages Flat Rate Benefits = (redacted) per person (annual) Trailing expenses = training/tuition + conference + travel + Office supplies/equipment + PC Leases/RTU + phone service + floor space Other Expenses Other savings include professional service and miscellaneous expenses, as presented in approved Project Information Worksheet #1146. Savings =(Approved Original PIW #1146$_{\text{Annual spend}}$ - Spending Against PIW #1146$_{\text{Acttual}}$) Approved Original PIW #1146$_{\text{Annual spend}}$ = approved spending for respective calendar year as per original, approved PIW.

Sample Contract Re-Negotiation Savings Calculation
Volume-Driven Pricing Contracts (Unit Price 1999$_{\text{Base}}$ - Unit Price$_{\text{Actual}}$) * Volume Non-Volume-Driven Pricing Contracts (Annual Spend 1999$_{\text{Base}}$ - Annual Spend$_{\text{Actual}}$)

13. The verification of the Company's cost and savings calculation methodology for the 35 sub-initiatives selected for testing indicates that the Company has made significant progress. However, at the time of our review, the effort was a work in progress and the Company has an appreciable distance to go.

    - A summary of the condition of the sub-initiatives selected for testing at the time of our initial review in October and final assessment in November is provided in Exhibit MIT-25 below.

Exhibit MIT-25
Status of Sub-Initiatives Cost and Savings Development and Support
Compiled from Information Provided Primarily as of June 30, 2000

Condition on October 17, 2000		Condition on November 10, 2000	
Description	**Number**	**Description**	**Number**
Process substantially complete at time of review.	13	Savings calculations are reasonable and support is adequate.	14
Problems discovered by MIT Analyst prior to BWG review. Continued analysis initiated by Company.	3	After adjustments disclosed by the verification process, savings calculations are reasonable and support is adequate.	4
Problems discovered by BWG or Company during process review. Follow-up required.	12	Work in progress requiring improved documentation or revised calculations.	8
Process considerably flawed. Company assessment continues.	2	Sub-initiative savings considerably dependent on unverifiable assumptions or estimates.	4
No savings to date or expected. Sub-initiative withdrawn.	5	Verification process shows no savings expected in 2000. Sub-initiative amended or withdrawn.	5
Total	35	Total	35

Source; BWG Analysis.

- In general, the problems discovered by the MIT Analysts prior to BWG's review and those discovered during the verification review process are minor and relatively easy to fix.

  ⇒ For example, savings for sub-initiative 6.2.1 relating to Network Planning and Engineering were expected to begin in June. An adjustment is required because in sourcing to take work from contractors had not yet begun. Further, wage offsets were originally based on the addition of 8 employees. This was changed to 17 employees based upon subsequent analysis by the Company.

  ⇒ Also, for sub-initiative 14.1.3 relating to Consumer Representative's training, the savings calculation originally applied full payroll related overhead loadings. This was changed because there are many dropouts during the training program and trainees are terminated before benefits are realized.

- Other problems were of greater magnitude requiring that the savings calculations or data elements used in the calculation be completely re-examined.

  ⇒ For sub-initiative 1.1.1 relating to Fleet Operations Vehicle Utilization, the information provided for review in October did not adequately document the savings calculation. The source of vehicle count information was said to be unavailable and unit cost information was incorrectly compiled. Following the verification review, the Company replaced its cost and savings calculations and related documentation in their entirety. Calculated net negative savings of $90,000 in June 2000 were reduced to zero in this subsequent analysis.

⇒ For sub-initiative 35.4.1 relating to Procurement Operations, the Company provided a savings calculation in October based upon line items shipped. During the review, we were advised that the Company believes that this approach overstates savings because it does not include a productivity factor. The Company is developing a revised methodology.

14. Confidence in the accuracy of the calculated cost and savings amounts varies considerably depending upon the sources of data elements used in the equations and the application of estimates and assumptions.

- A summary of the sources of data elements used in the calculation of cost and savings for the sub-initiatives selected for testing is provided in Exhibit MIT-26 below.

Exhibit MIT-26
Sources of Data Used in the Calculation of Cost and Savings

Description	Number
Accounting System Report	13
Operating System Report	14
Internal Study or Report	8
External Study or Report	5
Merger Team Estimate, Assumption or Analysis	17
Budget Overlay	8
Total	65

Note: Total is greater than 35 because many sub-initiatives require multiple calculations using data elements from more than one source.

Source: BWG analysis

- In general, the most reliable calculations are based upon budget overlays. These include the use of baseline and current budgets for entire programs or departments.

⇒ Savings in sub-initiative 34.B.1.2 relating to the cancellation of certain Information Technology projects are determined based upon the amount of funding authorized for the canceled projects.

⇒ Savings in sub-initiative 16.2 relating to AIT Corporate Brand Name advertising are based upon the amount of funding previously included in the approved budget.

- Savings based upon external studies are also highly reliable. Examples include actuarial reports used in the savings calculations in sub-initiative 29.2 relating to post retirement employee medical benefits and an audit report which is the basis for the determination of savings related to CLEC reciprocal compensation in sub-initiative 39.J.

- Data elements contained in accounting system reports are in general easily obtained and adequately supported. These include payroll and human resources reports relating to wages and severance payments, and accounts payable distribution charged to specific merger related responsibility codes for contractor charges, for example.

- Data elements contained in operating system reports are also easily obtained but often require manipulation before they are useable in the savings calculations.

  ⇒ A simple example is found in sub-imitative 18.2.1, which employs data from a call center operations reports in which call duration is measured in seconds and must be converted to hours before being used in a savings calculation equation.

  ⇒ A more complex example using the same sub-initiative and call center report requires estimating the time that call center personnel are required to be on the "Board" before savings related to shortened call duration can be determined.

- Some data elements are based upon estimates and assumptions and are not subject to verification.

  ⇒ Savings in sub-initiative 18.2.1 relating to Operator Services are supported by automated call center call volume and duration reports. However, the raw data contained in these reports is modified for use in the savings calculations through application of a series of assumptions. For example, the ANI failures volume is assumed to have stabilized at the level of 6,402 reported for March 2000. Further, it is assumed that the duration of an ANI failure call is one-fourth the time of an average call. Although these assumptions may be reasonable, they are not subject to verification.

  ⇒ Procurement savings in sub-initiative 59.2 establishes a 7 percent savings target of which 2 percent is assumed to be non-merger related. Merger savings will be reduced by the Business as Usual adjustment factor. Again, although this assumption may be reasonable, it is not subject to verification.

15. Some of the issues discussed with the Company during the sub-initiative review will result in procedural changes for the merger teams.

- For sub-initiative 27.1 – External Affairs, our review resulted in the correction of one severance payment listed in error. The Company proposes to initiate a year-end procedure for a comprehensive review of the Severance Report.

- For sub-initiative 31.1.10 – Increase Class Size for Consumer Initial Training, the merger team analyst noted an inconsistent method of documenting field information and determined that the savings calculation required further analysis and better documentation.

16. During the review of the 35 sub-initiatives selected for testing, the Company proposed adjustments or alternative treatment of savings that bear directly on allocations to Illinois.

    - For sub-initiative 18.2.1, Operator Services – Methods and Technology Best Practices, SBC proposes no allocation of the revenue savings to Illinois. SBC does plan to allocate the expense savings to Illinois.

    - For sub-initiative 21.5.2 relating to reduced bad debts expense, the Company has taken the position that because bad debts expenses is classified as a contra-revenue account in the USOA, this initiative should be considered a revenue enhancement and therefore not eligible for sharing of savings with ratepayers in Illinois.

    - For sub-initiative 29.3.1 relating to the granting of stock options, the Company proposes to claim a savings offset for Illinois by recording the compensation value of the options on the Ameritech Illinois regulated books of account. However, the Company does not intend to record this cost on the books of companies in other regulatory jurisdictions and because the Company uses the "disclosure only" option under FASB 123, the cost of the options will not be recorded for shareholder financial reporting purposes.

    - For sub-initiative 39.J. – Reciprocal Compensation, SBC proposes that there should be no savings allocated to Illinois because the program merely corrects an error. The Company rationale is that the audit program that results in lower payments to CLECs is an enforcement action relating to existing interconnection agreements approved by the Commission.

17. Planned savings associated with five of the 35 sub-initiatives selected for testing proved to be spurious and estimates for the year 2000 are overstated by $22.0 million.

    - A summary of the sub-initiatives selected for testing with reduced savings estimates is shown in Exhibit MIT-27 below:

Exhibit MIT-27
Sub-Initiatives with Reduced Savings Estimates

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- The adjusted savings amount is 7 percent of the $309 million in planned savings for the year 2000 for the 35 sub-initiatives selected for testing.

18. SBC uses a variety of methods for calculating merger team labor-related savings. With minor modifications, most of the approaches used are reasonable and, where practical, are consistent in similar situations.

    - Of the 35 sub-initiatives selected for testing, 17 or almost half, are expected to produce labor-related savings as shown in Exhibit MIT-28 (page following).

    - Labor savings in six sub-initiatives (3.3.7, 17.1.1, 26.1.10, 27.1.4, 31.1.10, 32G.3) will result from force reductions. In these cases, the savings will be calculated based on the actual salaries of personnel who retire, are terminated or move to another organization. Where appropriate, the savings calculations include a reduction in benefits and other non-wage expenses. Also, where appropriate, calculations include savings offsets for severance and relocation expenses.

    - Another five of the sub-initiatives (8.1.1, 8.4.1, 8.4.2, 11.1.1, 56.2.1) will produce labor-related savings resulting from increased productivity. These savings will be realized based on avoided cost rather than force reductions. Thus, the productive hourly wage rate is used to calculate the amount of the savings. The productive hourly wage rate is defined as total pay for both productive hours (on the job, with straight and overtime pay included) and non-productive hours (vacation, sick, holidays, etc.), divided by productive hours. Savings for trailing expenses are not included, because the savings do not result from a force reduction.

Exhibit MIT-28
Sub-initiatives Producing Labor-Related Savings

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- The labor-related savings from sub-initiative 35.4.2 also result from increased productivity. However, the Company has provided a savings calculation that is based on actual wages, including overtime, for the non-management personnel involved in the recommendation. Again, trailing expenses are not included since a force reduction will not occur. While it is appropriate not to include the trailing expenses, using the actual monthly wage rate will understate the savings, because a productivity factor is not included in the calculation.

- Labor-related savings from three of the sub-initiatives will be based on process improvements that eliminate time, and employee hours, from the processes, but do not amount to force reductions. In two of these cases, 14.1.3 and 14.3.1, the Company indicated that savings will be calculated using an actual average hourly rate, including overtime, for the employees involved. This is similar to the approach for calculating labor-related savings in 18.2.1, and is appropriate since time saved by each individual employee will not be captured.

- Data sources and calculations for sub-initiative 18.3.4 are the same as for 18.2.1 above. Labor-related savings are generated via a process improvement that reduces employee work time. The savings calculation approach is reasonable; however, since this practice was already in place at AIT, no savings will be realized in Illinois.

- Sub-initiative 34.B.1.2 produces savings through the cancellation of certain IT initiatives that were funded in the AIT budget prior to the merger. The proposed savings are the result of a before and after budget overlay. The MIT has not yet calculated the wage savings related to these budgeted but unfilled positions because the HR department has not yet determined the cost of the vacant positions.

- Sub-initiative 11.1.6 was intended to generate labor-related savings based on implementation of a new technology. The Company subsequently determined that the new technology would have been employed by AIT regardless of the merger. Thus, the savings are now considered to be unrelated to the merger, and are not included.

Quantified Results of Investigation

Not applicable in this chapter of the report.

Recommendations for the Company

1. Before issuing the Year 2000 Merger Costs and Savings Report, develop a systematic process for review of input to the Oracle database for all sub-initiatives. The review process should be documented with formal written procedures and should be supported by checklists to demonstrate that established procedures were followed. Transition Planning management personnel should sign off on the checklist for each sub-initiative to indicate their review and approval of the cost and savings calculations. (Refers to Conclusion No. 4)

2. Review sub-initiatives that contain data elements that are currently not subject to verification (see 18.2.1 and 56.2.1 for example) to determine if an alternative calculation of savings would reduce reliance on undocumented estimates and assumptions. Alternatively, perform the additional analysis needed to document the assumptions used. (Refers to Conclusions No. 13 and 14)

Policy Issues for the Commission

1. Develop guidelines for the Company to follow in reporting costs for sub-initiatives that have not produced savings in excess of costs at the date reports are filed. This issue involves the question of the time period and level of detail for which the Company must demonstrate that the costs of its merger initiatives are producing savings. In addition, consider extending the three-year period for sharing of net merger savings to ensure an equitable apportionment to the Company and its ratepayers. (Refers to Conclusions No. 7 and 8)

2. Review the Company's stated position regarding the proposed treatment of costs and savings in sub-initiatives 18.2.1 – Operator Services, 21.5.1 – Bad Debts Expense, 29.3.1 – Stock Options, and 39.J – Reciprocal Compensation to determine if the proposed treatment is acceptable. (Refers to Conclusion No. 15)

Future Audit Issues

1. In establishing the scope of the audit of the Year 2000 Cost and Savings Report, design the audit to focus on five principal areas: 1) Merger Cost and Savings Calculations, 2) Merger Cost and Savings Tracking, 3) Illinois Savings Allocations, 4) Assignment of Costs to USOA Accounts, and 5) Part 32 and 64 Allocation Factors. (Chapter VIII – Merger Integration Teams)

   - Because there are more than 400 sub-initiatives with planned savings in the year 2000, we recommend that the audit of reported costs and savings be performed on a statistical or judgmental sampling basis.

   - The verification of Part 32 and Part 64 allocation factors should be performed for all USOA accounts with significant Illinois merger costs or savings. Tests should be made to ensure that allocations are based upon the most recent reliable data.

   A summary of audit areas to be addressed in the audit of 2000 reported costs and savings is shown in Exhibit MIT-29.

Exhibit MIT-29
Audit of 2000 Reported Costs and Savings
Recommended Audit Areas

Audit Area	Issues	Scope
Saving Calculation Methodology	• Is the overall savings calculation methodology appropriate? • Is the data used in the savings calculations from a reliable source and is the data appropriately used? • Does the Oracle merger database contain correct cost and savings information?	Selected sub-initiatives
Merger Cost Tracking	• Are the costs properly associated with the merger sub-initiative? • Does the Oracle merger database contain correct savings information?	Selected sub-initiatives
Illinois Cost Allocation (Illinois Allocation Decision Trees)	• Has SBC identified and applied reasonable cost allocation methodologies?	Selected sub-initiatives
Assignment to USOA Accounts	• Are sub-initiative costs and savings assigned to proper USOA accounts?	Selected sub-initiatives
Part 32 and 64 Allocation Factors	• Are Part 32 and 64 allocation factors calculated correctly?	All USOA accounts